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TAGS: EFIN ECON ETRD EINV ET
SUBJECT: ETHIOPIA: EXCHANGE RATE DEPRECIATION

¶1. (SBU) Summary: The Ethiopian birr depreciated 1.6 percent against the US dollar from the beginning of December 2006 through February 2007 - nearly as much as the birr had slipped in the previous five years. The National Bank of Ethiopia (NBE, the country's central bank) follows a managed float exchange rate regime, intervening as it deems necessary to smooth excess volatility in the market. The recent acceleration in the birr's depreciation appears to be a new GOE effort to reduce import demand and so mitigate pressure on the country's scarce hard currency reserves, but this approach will likely stoke inflation. Falling assistance inflows last year compounded Ethiopia's chronic trade deficit; sizable hard currency outlays to finance Ethiopia's military presence in Somalia is also adding to the problem. Additional liberalization of the economy, and resulting foreign investment, would appear to offer a better strategy for easing pressure on foreign exchange markets. Overall aid flows are also likely to remain unpredictable as Ethiopia continues its bumpy democratization process. Compounding the economic picture is a 27 percent inflation rate in the past six months. End Summary.

BIRR HOLDS MOSTLY STEADY FOR FIVE YEARS,
WITH OFFICIAL HELP

¶2. (SBU) The birr, Ethiopia's currency is pegged to the US dollar. The GOE claims to follow a managed float (aka "dirty float") exchange rate regime. Prior to October 2001, the exchange rate was determined by the Dutch-type weekly foreign exchange auction market. The marginal rate derived from the auction used to serve as an official rate used for transactions for the week following the auction. Since October 2001, however, the exchange rate of the birr has been determined by the daily inter-bank foreign exchange market in which the National Bank of Ethiopia intervenes to regulate the movement of the exchange rate. Over the past five years, the exchange rate of the Birr against the US dollar has been steadily and slowly depreciating by Birr 0.0001 on a daily basis. In October 2001, the rate was 8.56 birr per dollar; five years later, in October 2006, the rate had fallen to 8.71 birr per dollar, indicating a cumulative depreciation of 1.7 percent. The IMF has argued that this regime in practice amounts to a fixed exchange rate.

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LOWER AID FLOWS; SURGING IMPOSTS STRAIN RESERVES
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¶3. (SBU) Over the last 18 months, however, the pressure on the exchange rate appears to be on the rise owing to the ever-increasing trade deficit as well as falling external inflows in the form of direct budget support and other assistances from foreign governments. The country's export receipts in 2005/06 totaled $1.0 billion, while the total import bill was $4.3 billion for the same period. The trade deficit with the U.S. aloe was over $400 million in 2006. The gap was financed - as it has been for many years, by

external inflows in the form of remittances, loans and assistance, debt forgiveness, and by running down NBE's reserves. The suspension of direct budget support by the World Bank and several donor governments in the wake of political unrest in November 2005 reduced assistance flows, however. Many of those flows have since resumed, but at a lower rate than expected. While Private remittances slightly climbed from $96 million in 2005 to $105 million in 2006, net public transfers shrunk from $836 million to $483 million in the same period) According to PM Meles, the GOE is also struggling with unexpectedly high dollar outlays to pay for the expenses of the Ethiopian military offensive in Somalia.

FASTER DEPRECIATION MAY WORSEN INFLATION

¶4. (SBU) The rate of depreciation of the Birr has increased rather markedly since December 2006. The exchange rate depreciated from 8.7067 birr/1 dollar at beginning of December 2006 to 8.8415 birr/dollar at the end February 2007 - a 1.6 percent drop. In addition to an accelerated daily 0.0001 rate of depreciation, the authorities allowed further depreciation by a significant amount on four occasions in December 2006 and January 2007, with the Birr dropping on average by 0.03 birr in each time. According to some economists at the NBE, the authorities are considering a shift in their longstanding strategy; depending on the pressure on Ethiopia's reserves, the bank may allow more depreciation of the Birr. Some Senior economists at NBE (protect) are concerned that more rapid depreciation of the local currency will reinforce the existing upward trend in inflation. Exchange rate depreciation will further erode the purchasing power of Ethiopians already reeling from significantly higher food prices.

COMMENT: ATTRACTING MORE FDI IS BEST STRATEGY

¶5. (SBU) Though understandable, the NBE's apparent efforts to discourage imports through accelerated depreciation of the birr may come at a high cost in terms of inflation. It will be difficult for the GOE to expand exports more quickly than it has so far and demand for imports is almost certain to remain high. Foreign aid flows are likely to remain volatile and determined in some measure by the unpredictable evolution of Ethiopia's democratization. Further liberalizing the economy would appear to be the best strategy to cope with this uncertain situation. Additional privatizations and reduction in the role of state and party companies in the economy would attract foreign resource inflows in the form of FDI, long-term concession loans, grants and commercial loans. End Comment.

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